EXHIBIT 2
DATE 3/30/11
SB 409

REPORT

MONTANA STATE RECREATION AND RESIDENTIAL LEASES

ANALYSIS OF THE PROBLEM AND A RECOMMENDED SOLUTION FOR ESTABLISHING ANNUAL LEASE RENTAL FEES

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EXECUTIVE SUMMARY

Presently the Montana Department of Natural Resources has 764 active residential and recreation leases on state trust lands.

For many decades lessees and the state had a harmonious relationship. But in the last 10 years, there has been an increasingly bitter battle between the lessees and state as **annual lease fees have increased to the point of forcing lessees off of their leased lots.**

The federal Enabling Legislation which granted these lands to the state and a recent Supreme Court ruling require the state to receive ***full market value*** when selling or leasing trust lands.

There is very little to no long term leasing of private land for residential or recreational purposes in Montana or the United States. So market data for setting annual lease fees is not available from the private sector.

Due to the lack of market rental data, numerous studies in Montana and Idaho have developed various formulas to set fees. These formulas are well intended, but have not solved the problem

The state, intends to implement a new lease fee setting process referred to as the 3B alternative.

Essentially, the 3B alternative will set annual lease rates at 5% of the Department of Revenue's appraised fee value of each lot, with a variable automatic annual escalation of a percentage between the CPI and 6.5%. There are some phase-in factors when lease fees increase substantially.

There is little to no local real estate market data that supports the 3B alternative.

As an example, using the 3B process, from 2007 to 2010, the 3B method would have increased annual lease fees by over 13%, while local real estate market values declined almost 30%.

Many lease fees have increased or are projected to increase to $8,000-$20,000 annually.

Most lessees are middle income Montana citizens who cannot afford these kinds of lease payments. The current high lease payments have made it impossible for lessees to sell their improvements on the open market. Most Realtors will not even list state lease property.

Many lessees are facing the dilemma of not being able to afford the new high lease fees and not being able to sell their improvements. Many will be forced to abandon their leases and face catastrophic financial loses.

Rather than implement the 3B alternative, **the state should immediately offer to lease some of the dozens of existing vacant lots. These new leases will provide both a cash flow to the trust fund as well as providing valuable local rental market data for setting reasonable lease fees on occupied lots.**

Both Montana and Idaho have failed in their recent attempts to lease vacant lots, during a very robust real estate market. This failure was caused by using 5% of the appraised fee value of a lot as a minimum bid. This is clear market evidence that 5% of fee value is above market rental rates.

A 2009 market rental study in Idaho indicated a 5% rental rate for $50,000 properties, with a decline to 2-4% for $100,000 to $300,000 properties. To be successful, the state's effort to lease vacant lakeshore lots should have much lower minimum bids. This will allow the open market to set rental rates.

Summary of the Qualifications of the Author: Warren Illi is a highly qualified real estate appraiser with 42 years of experience appraising, review appraising and administering leased recreation and residential lots owned by the U. S. Forest Service, State of Montana and Bureau of Reclamation. He has worked on both the governmental and private side of the leasing issue. He currently operates a real estate appraisal and consulting business, specializing in rural and recreation properties. Due to time and funding constraints, most of this analysis and discussion will involve state lake front leases in Western Montana. But the lease fee determination principles and conclusions are identical for river front, lake view and residential leases.

CURRENT SITUATION

The State of Montana currently has 802 residential and recreation lots available for leasing, with about 764 active leases. Leased lots annually generate in excess of $1,500,000 for the beneficiaries, primarily various school trusts.

These lots were initially leased in the 1950's and 1960's for nominal rates. During the mid to late 1990's lease fees began to increase substantially. This initiated a long battle between the state and lessees. New legislation and court decisions have not solved the problem. Now this controversy has tainted state leases to where the lessees cannot sell their improvements on leased land. Potential buyers are avoiding state leases like the plague and cash flow to the State Trust Fund will likely be reduced.

Because of the initial low lease rates, many leases were acquired by Montana residents with modest incomes. These lessees generally could not afford to buy private property, especially lakeshore property.

During the mid to late 1990's, annual lease fees were increased substantially, beyond the economic affordability of the original lease owners. So many of the leases were then acquired by middle income Montana citizens. They could afford the higher $1,000 to $3,000 annual lease fees.

Since 2003, and especially since 2009, annual lease fees have increased substantially. They are projected to increase to $8,000, and sometimes to over $20,000 per year. This puts the affordability of these leased lots beyond the economic reach of most middle income lessees. On Rogers Lake, the high fees have forced 22 of the 34 state lessees to attempt to sell their lease improvements. No accurate number is known, but it is likely that at least 100 to 200 lessees are attempting to sell their improvements, but with little luck. Dozens of real estate listings for state leases have expired without any meaningful offers to purchase. Due to the current and projected high cost of state leases, and the lack of market interest in state leases, Realtors are refusing to even list private dwellings on state land because they know these lots cannot be sold because of high lease rates and uncertainty about future lease fees.

What is particularly alarming to lessees is the probable loss of their investments in their homes and cabins on state lease lots.

LEASEHOLD VALUE When lease fees were nominal, lessees enjoyed a "positive leasehold interest" on their lease lots. A positive leasehold interest is formed when the contract rent (lease fee) is less than the market rent (what it should lease for). So lessees were able to sell their cabins for much more than the real value of the structure. Buyers paid a premium for a cabin in order to have the financial advantage of the below market rent for the lot.

Now with lease fees (contract rent) exceeding market rent, a "negative leasehold interest" has developed. A negative leasehold means the lessee must accept less than market value for their improvements in order to sell their property. Buyers, if any, require a substantial discount in the value of the improvements to compensate for the high land or lot rental fees.

Many lessees are facing the dilemma of not being to afford the new high lease fees and not being able to sell their improvements. Many will be forced to abandon their leases and walk away from tens-of-thousands or hundreds-of-thousands of dollars of lessee improvement value. This will be financially devastating to many lessees.

Lessees without the financial resources to pay the high lease fees and unable to sell their improvements will increasingly resort to exercising the abandonment option in the lease. The abandonment option will result in the suspension of lease payments for up to 3 years with no income to the trust fund.

Lessees feel the state has violated the state's fairness doctrine in dealing with them. Lessees fully acknowledge that lease rates were below full market rental rates for many years. But that wasn't caused by lessee actions, but was a failure of the state to properly set lease fees.

The state is now proposing to raise annual fees well beyond any lease fee that can be supported by local real estate market data.

Privately owned lakeshore property is very expensive and lakeshore cabins or homes are rapidly being owned only by wealthy citizens or citizens lucky enough to inherit a lake place.

The real estate market is also clear that wealthy citizens will not pick up state leases as middle income citizens did in the 1990's.

LACK OF MARKET RENTAL DATA The 2008 University of Idaho's Cook and O'Laughlin report reiterated when other studies have shown, "Land leases for single-family residential use properties are rare in the United States". Long term leasing of private lakeshore for recreation and residential purposes is not found in the private sector. Only government agencies and a few out-of-state corporations such as power companies have long term residential or recreational leases. If private lakeshore property is available, wealthy citizens with investment dollars prefer to buy private lots. They are not interested in state lease property, especially leased property with rapidly increasing annual fees and the likelihood of even higher fees in the future.

So the state is faced with the dilemma of trying to lease very valuable lakeshore property that middle income citizens cannot afford and wealthy citizens do not want. This is likely to result in reduced income to the beneficiaries as leases are abandoned and litigation occurs.

Rather than simply walk away from their valuable improvements, lessees are uniting together and litigation will occur. The proposed leased fee increases for the next six years for the 286 state leased lots administered by the Northwest Land Office will increase by an average of $5,207 per year (Page 5 of State 2009 Lease Report). When multiplied by the six year appraisal cycle and the 286 active leases, the result is fee increases of nearly $9,000,000. So lessee initiated litigation is a necessity not an idle threat.

The Enabling Act and the Montana State Supreme Court decision clearly mandates that state trust lands are to be administered to return "...full market value..." to the beneficiaries.

As mentioned earlier, there is virtually no long term leasing of private land for residential and recreation purposes. So there is virtually no private sector market rental data to guide the state in setting lease rates.

Recently the state has evaluated several possible alternative methods for setting lease rates. The method being adopted by the state is known as Alternative 3B.

Essentially the 3B method sets annual lease rates at 5% of the appraised fee value of each lot plus a variable annual escalation fee. 3B also includes some phase-in procedures when lease fees increase substantially.

The 3B procedure will result in very substantial increases of lease fees and even higher fees in the future.

SUGGESTED SOLUTION

There is virtually no private market sector lease data available. But the state holds the opportunity to develop excellent market data for market rental rates.

Legal Mandates There are really only two key legal mandates, the Enabling Act and Supreme Court mandates for leasing state land. Both of those authorities require the state to obtain "full market value" for state leases.

Nowhere does the Enabling Act, Constitution or court ruling require a 3.5% annual return or a 5% annual return. Nowhere do these authorities require that lease fees be established as a percent of fee value. Nowhere is there a requirement to annually escalate of lease rates.

Due to the lack of leases in the private sector, administrators and consultants have concocted numerous convoluted formulas and methods to establish lease fees. All of those techniques were developed in an earnest effort find a cure for the lack of private sector market rental data.

But all of these formulas include numerous assumptions and conditions not derived from the real estate market.

Meanwhile, the state holds the key to developing the best market data available.

The state has dozens of unleased lots. The state could promptly solicit bid offers for these vacant lots. Within a matter of 3 to 6 months, the bids on these currently unleased lots will provide valuable market data on the current market value of state leases. That data can be reasonably expanded to develop market supported full market value rental rate for other state leases.

These new lease rates will withstand any court challenge because they are market derived.

A word of caution. The state has offered several new leases in the last several years, but has received only two viable bids. One new lease was dropped within two years.

One of the problems with the state's bid process was that the minimum bid was 5% of the fee value of the lot. Those bid minimums were offered to the public during the most robust real estate market in the history of Montana.

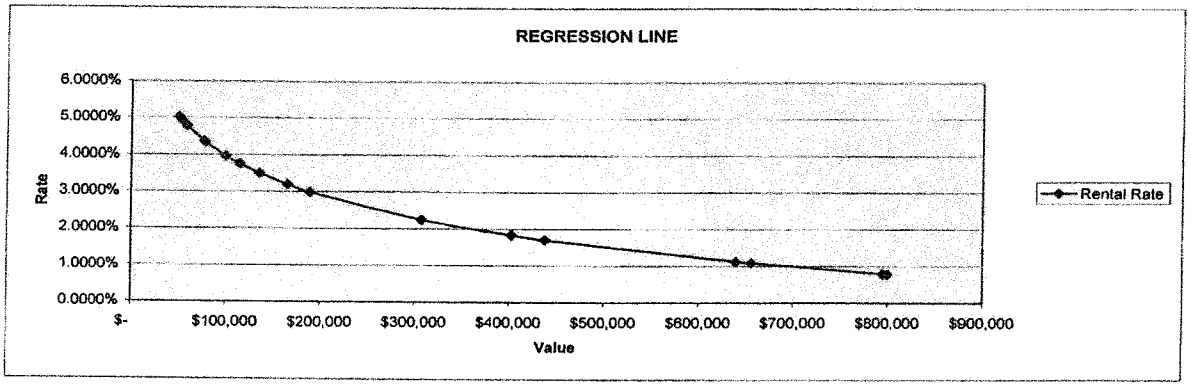
During this bid offer period, private lakeshore property was selling like hotcakes at increasingly high prices. But no one wanted state leases. Even the State of Idaho offered two new leases on popular Priest Lake, with a minimum bid of 5% of fee value or $22,000 per year. There were no bids. ***That is clear market evidence that 5% of fee value is too high and above market rates.***

In addition, potential bidders faced higher future fees, even as market value for rural real estate was dropping.

2009 Idaho Study A very recent study in Idaho provided the following data on lease rates for recreation real estate.

EXHIBIT B

			Logarithmic Curve Fit y=A+B(ln X)	
	0.037617035		A =	0.215712
			B =	-0.015301
Rent/yr	Rent/mo		ln x	y
1,881	$	157	10.8198	5.0159%
1,995	$	166	10.8788	4.9255%
2,201	$	183	10.9768	4.7756%
2,878	$	240	11.2450	4.3652%
2,934	$	245	11.2645	4.3354%
3,762	$	313	11.5129	3.9553%
4,317	$	360	11.6505	3.7448%
5,078	$	423	11.8130	3.4961%
6,198	$	517	12.0123	3.1911%
7,110	$	592	12.1495	2.9812%
11,561	$	963	12.6357	2.2374%
15,136	$	1,261	12.9052	1.8250%
16,469	$	1,372	12.9895	1.6959%
24,075	$	2,006	13.3692	1.1150%
24,699	$	2,058	13.3948	1.0758%
29,880	$	2,490	13.5853	0.7844%
30,094	$	2,508	13.5924	0.7735%



The above graph illustrates that lower value property, up to $50,000 can provide an annual return of 5%. But as property value increases to $200,000 and $300,000, the annual rate of return drops to 2-3%.

This documents why both Montana and Idaho failed in their attempt to get bids at 5% of the fee value of vacant lots. **The market simply will not pay an annual rate of 5% for high value property.** Instead, those buyers who could afford an annual state lease fee of $8,000 to $20,000 prefer to make a down payment on a private lot and pay a mortgage in lieu of making rental payments. Therefore at the end of 20 years they own a high value lakeshore property instead of just having a pile of rent receipts (lease receipts). In addition, at the end of the 20 year mortgage period, their lake front property lot is highly likely to be worth much more than their purchase price.

To be successful, the state's new offer to lease existing vacant lots must be in touch with today's market. We are in a recession and the former red hot real estate market has turned sour.

RECOMMENDED BID PROCESS

I recommend the state offer to lease 1-3 lots on several different lakes to develop new market rental data. Some ideas to encourage competitive lease bidding should include:

1. **Minimum Bids** The minimum bid should be based on an amount that will generate income in excess of the cost to administer the lease. For lakeshore lots, I suggest a minimum fee of $1,000 or 3/4 of 1% of the DOR appraised value, whichever is greater. A $200,000 lot will have a minimum bid of $1,500 using 3/4 of 1%. This amount is generally equal to the real estate taxes on real estate. A minimum bid of 5% of a lot's fee value will likely eliminate all bids. Minimum bids for none lakeshore lots will have to be lower than $1,000.

2. **Lease Period and Escalation** The bids solicited should be on an annual basis for each year of a 5 to 10 year lease period. This lets the bidder or market establish the escalation or deflationary factors. Annual fees increases tied to the CPI or most other real estate indices have little relationship to Western Montana lakeshore values.

3. **Bid Guarantee** The bid process should include a sizeable bid guarantee to discourage speculative or manipulative bids. I suggest a bid guarantee of one-half the first years lease bid.

4. Offers to bid on these lots must be very well advertised and promoted.

5. During this bid offering for existing vacant lots, a few lessees may choose to voluntarily open their leases for competition bidding. This necessitates developing a method to handle lessee improvement value in advance of offering the leased lot. Lessees with improvements will also have to open their cabins or homes for bidder inspection.

6. The bid process should also include the right for the state to reject any and all bids. That way the state can choose not to accept any bid if something unforeseen or unacceptable occurs.

The bids on these lots should provide excellent current market data that can be analyzed to set lease fees for the remaining lots. One method is to develop a ratio between bid prices and DOR's appraised values, then apply that ratio to set annual fees other lots.

I predict these bids will likely come in lower than state officials would like to see. This will be caused by the current recession and the current state lease controversy. ***But this is the current market!***

Prospective bidders for a 5-10 year lease period will likely be people with RV's. That way, if the state lease situation becomes untenable at a future date, they can simply drive off. Twenty to thirty year lease periods with predictable future lease fee changes, will be necessary for new lessees to confidently build substantial homes and cabins.

ADDENDA

A. DEFINITIONS

Full Market Value - Full market value is currently defined by Rule 36.25.102, ARM, as *"the most probable price in terms of money that a property will bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently, knowledgeably, and assuming the price is not affected by undue stimulus."*

Market Value* - *The most probable price that a property should bring in a competitive and open market under all conditions requisite to a fair sale, with the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus.*

Note: There are many definitions of market value, but the above two definitions contain all the essential elements of most market value definitions.

Positive Leasehold* - A lease situation in which market rent is greater than the contract rent.

Note: In the past, a positive leasehold existed on many state leases because state lease fees were less than market rents (lower than they should be), therefore lessees selling their improvements were paid a premium for their cabins so buyers could have the advantage of the bargain lease rates.

Negative Leasehold* - *A lease situation in which market rent is less than contract rent.*

Note: This is the current and future leasehold situation because contract rents (state lease fees) are above market rents (lease fees are too high). This will result in the loss of typical home and cabin values because buyers will demand a discount of improvement values to compensate for the high lease fees. In some cases, if the lease fees are too high, the improvements cannot be sold at any price.

When contract rent (annual lease fee) equals market rent, the leasehold value or estate has no value except for the value of the tenant owned improvements.

* Dictionary of Real Estate Appraisal, 5th Edition published by the Appraisal Institute, 2010

B. Evaluation of State Lease Proposal 3B

There are three problems with the 3B proposal.

1. Use of 5% rate
2. Use of appraised fee value of lots
3 Use of an annual escalation fee

1. 5% Rate Both the Enabling Act and supreme court ruling refer to "full market value". Nowhere do these authorities specify using 5% or any other percentage. There is nothing wrong with using a percentage if that percentage is derived from real estate market data pertinent to the local market where the leases are located.

Page 13 of the state's 2009 Analysis of Lease Rent Calculation Alternatives for Cabin Sites on Montana's State Trust Lands, hereinafter referred to as the State Lease Report, cites the rate of AAA Bonds, Treasury Bills, the 17 year old Duffield Study, California lease rates and other investment rates of return that have little or nothing to do with local real estate values, real estate land rental rates or current values.

The problem with finding the correct percentage is made difficult, if not impossible, because there is no long term leasing of lake front lots in the private sector. This is not just the situation in Montana, but nationwide. So government agencies try to find other investment indicators to use when setting lease fees.

Total Rate of Return When determining a fair rental rate consistent with the mandate to get full market value, the state should consider both the annual income and as well as the appreciation in the value of the real estate asset. The 2008 University of Idaho lease income study of lease problems in Idaho, reported Idaho leases were returning 13% annual appreciation, even with an annual cash rate of return (lease rate) of only 2.5%. The state land was appreciating at the annual rate of 10-11%, giving an overall rate of return of 13%.

This is similar to growth and income equity stocks. Investors usually have a choice of buying income stocks which provide a high 4-7% annual income stream (cash dividend), but low potential for asset appreciation. A growth stock generally provides little or no annual income but a high potential for asset growth. Seldom will an equity stock produce high annual dividend yields as well as growth in the value of that stock.

No one will dispute the rapid value growth of the state's lakeshore assets. So for the state to also expect a high rate of annual cash return is desirable, but not likely.

Forest Service Use of 5% The U. S. Forest Service has more recreation lot leases than any other government agency. They use a 5% rate, so Montana plans to use the 5% rate and Idaho appears to be headed to implementing a 5% rate. A former Chief Appraiser for the Forest Service, Paul Tittman, could not provide any market derivation for the 5% rate used by the Forest Service except that it has been the rate used for many decades.

As a former Forest Service appraiser of leased lots and administrator of the cabin lease programs, I know the Forest Service has used many gimmicks to retain the 5% rate, but keep fees reasonable. For instance, many lot lease fees were reduced by reducing lot sizes from 150 feet of lake frontage to 100 feet of frontage. This reduced lot lease rates by 33% while retaining the 5% rate. Currently Congress is considering legislation to reduce lease fees because 5% of the fee value of the lots results in unreasonably high lease or permit fees.

Financial Impacts on Lessees The use of 5% of fee value works well for low value property. On page 5 of the State Lease Report, the following data is available:

For Eastern Land Office- Average full 2009 rent is $431
- Average full 2003 rent was 271
Increase is $160 per year or $3 per week

For Northwest Land Office-Average full 2009 rent is $8,351
-Average full 2003 rent is 3,144
Increase is $5,207 or $100 per week

Comparing the increases between the Eastern Land Office and the Northwest Land Office indicates that leases in Northwest Montana will increase 30 times more than in Eastern Montana. Has the ability of Western Montana lessees ability to pay increased 30 times as much as Eastern Montana lessees?

This is exactly why Western Montana lessees are so upset. Proposed lease rates are unacceptable high.

Two market indications of recreation lease rates in Western Montana show a much lower rate of return.

Lease of Private Lake Lot The Conner lease is the lease of a vacant lot on Crystal Lake. Crystal Lake is a high quality lake located about 15 miles west of McGregor Lake. The Conner's own a lake lot improved with a modest cabin. They rent an adjacent vacant lake lot for $800 per year. They use the vacant lot to park their RV for overflow summer guests. The vacant lot is owned by out-of-state landowners. Part of the reason for leasing the lot is to have the Conner's keep an eye on the lot to keep it from being trashed. In 2007 the lot adjacent to the leased lot sold for $285,000 cash. The leased lot is significantly better, so it is reasonable to say it is worth at least $300,000. Based on the 2009 lease fee of $800, ***the rate of return for this privately leased lot is 2/10th of one percent.*** The Conner's expect to pay a $900 lease fee in 2010, which increase the lease fee very slightly.

Marina Lease A recent ad for selling and leasing boat slips in Bigfork Marina indicated sale prices for a boat slips range from $71,200 to $86,400. Those same boat slips can be rented on an annual basis for $1,850. ***Using an average listing fee price of $78,800 and an annual rental of $1,850, indicates a rental rate of 2.3%.*** Keep in mind this rate of return is for an improved property, not raw land like the state is leasing.

Test of the 5% Lease Rate In 2005 and 2006, during the height of the real estate boom in Western Montana, the state attempted to lease several lots of Rogers Lake. The minimum bid was 5% of the appraised fee value of those lots. Only one bid was received. That new lease has since been terminated.

The state also attempted to lease lots overlooking Blue Bay on Flathead Lake. Again the minimum bid was 5% of fee value. Only one bid was received and that has been dropped.

During this same period, the State of Idaho attempted to lease two lots on popular Priest Lake. Again the minimum bid was set at 5% of fee value or $22,000 per year. Again, no bids were received.

These repeated failed attempts to lease new lots at 5% of fee value clearly demonstrates that the minimum bids, based on 5% of fee value, were far above market rents. These attempts to lease vacant lots occurred during a very robust real estate market in Western Montana and North Idaho.

The 2009 study in Idaho, funded by the State of Idaho provides good market evidence that lease rates of return drops dramatically as land values increase. That study which is summarized on Page 17 of this report, clearly shows that a 5% rate of return is appropriate for low value property, under $50,000. But as property values increase, the rate of return quickly drops to a 2-3% rate of return.

In summary, there clearly is no market evidence to show that lease or rental rates for recreation property in Western Montana should provide a 5% or higher return. In fact the limited data available, clearly indicates a much lower rate of return for higher value property.

2. <u>Use of Appraised Fee Value of Lots</u> The 3B process uses the DOR estimate of fee lot value as one of the two factors in setting base lease fees.

The 3B lease fee method makes the wrongful assumption the fee simple property rights are identical to the rights held by the lessees with state leases. That is not correct.

The EQC report prepared by their legal staff, states, "...the value of the lease should reflect, at least in part, the full market value of the fee simple property itself less any restrictions or conditions placed on the lease." This is another confirmation that fee simple ownership rights are different than leasehold rights.

Lessees Don't Get Property Appreciation A fee landowner has the right to sell his lot at a profit. Lake shore values have increased tremendously over the last 10-15 years, with a possible slight reduction during the last 2-3 years because of the recession. The Conner's lot on Crystal Lake, mentioned on the previous page, was acquired in 1992 for $300 per front foot. In 2002, the adjacent lot, virtually identical to the Conner lot sold for $880 per front foot. In 2007 another lot on Crystal Lake sold for $2,800 per front foot. These sales indicate a major benefit of fee ownership, the right to enjoy

capital appreciation on a lakeshore investment. These trends in lakeshore values are not abnormalities, but typical for lakeshore property value trends throughout Western Montana.

Lessees do not enjoy any appreciation of lease lot values. In fact, just the opposite is true. As lakeshore prices increase, lessees are required to payer higher and higher lease fees for leasing the same lot.

In summary, leased lot owners do not enjoy the value appreciation found in fee owned lots. Yet this is not recognized when using fee lot values to establish lease fees.

Sub-leasing Income Fee landowners also have the right to lease their lots and cabins to derive income and help offset taxes and upkeep. State lessees must receive advance written approval of the state prior to sub-leasing a state lot. Only one sub-lease per year is permitted. That rental cannot exceed their state lease fee. This significantly reduces the potential cash flow from a lake home on leased land. This lease limitation is not recognized when using the fee value of lakeshore to derive lease fees.

Number of Dwellings Only one dwelling per lot is allowed on state leases. Additional buildings may require a fee adjustment. Many privately owned lots do not have this restriction.

Tree Ownership Another limitation of a state lease is the ownership of trees. When a private landowner decides to cut a green tree on his lot, he makes the decision to cut or not cut. He can cut the tree without any kind of payment. State lessees must get state permission to cut green trees on leased lots and then pay the state for the value of that tree. This lease restriction is not recognized when using fee values to set lease rates.

Lakeshore Development Restriction Lessees on state leases are also restricted from putting any improvements, except docks, within 100 feet of the lake. This is not a limitation on most privately owned fee lots.

Taxes Improvements on leased land are taxed as personal property, which has a higher tax rate than an identical improvement on private fee land.

A special fee is assessed when lessee improvements are removed from the lot.

All plans for development and improvements, including alterations, must be approved in advance by the state.

No soil, trees or other vegetation may be removed from state land without prior permission from the state. Advance permission is required to remove dangerous trees, limbs and other hazards that pose risk to improvements or injury to individuals.

Overall, the list of the property rights enjoyed by private landowners is significantly different than the limited rights granted in state lessees. The leases contain many restrictions on property use and enjoyment not found on private land.

To base lease rates on fee property rights and not recognize the limited rights granted in the lease is not an appropriate valuation technique.

In 1983 and 1989, the legislature acknowledged the difference between lease rights and fee rights by providing a 30% discount in lease fee determination to compensate for these limitations. The 3B method does not recognize any difference between lease rights and value, and fee rights and value.

3. Use of an Annual Escalation Fee The 3B method includes the use of an annual escalation fee based on the assumption that real estate values always go up. It is an attempt to maximize income to the beneficiaries by eliminating the lag time between 5 or 6 year updates of lot values by the DOR, again assuming real estate always goes up every year.

The state's 3B method proposes to annually increase lease fees between 3.25% and 6.5%. The low bound of 3.25% is average annual increase in the CPI from 1983 to 2008. The high bound limit of 6.5% is the average annual appreciation of real estate from 1983 to 2003.

Both of these indexes were used because they are readily available and no state funds are needed to gather this data. Economics played a role in deciding to use these indices.

Unfortunately, neither index has a direct relationship to the Enabling Act or court mandated direction to get full market value.

The CPI (consumer price index) is a broad national index that measures consumer spending. It frequently is used as a measure of inflation. It measures price trends for a market basket of consumer costs. These costs include the price of breakfast cereal, clothing, wine, college tuition, gasoline and dozens of other consumer products. My question is, "what does the price of a box of Wheaties have to do with lakeshore price trends in Northwest Montana"?

Similarly the CPI is a measurement of prices in urban areas, not rural areas. It specifically does not measure economic trends in rural areas where the state leased property is located and **it very specifically excludes real estate values.**

University Study The 2008 University of Idaho study states, "the application of an index of overall price change in the economy, such as the Consumer Price Index, does not accurately reflect price change in the real estate markets at Priest Lake and Payette Lake."

Below is a 10 year comparison of the CPI and vacant land sale prices in Northwest Montana.

YEAR	C-CPI-U	Change in CPI from Previous Year	Average Value of Vacant Land Sold in NW Montana MLS *$ per Tract*	Change from Previous Year
1999	167		83,606	
2000	172	2.9%	99,065	+18.5%
2001	177	2.9%	97,515	- 1.6%
2002	180	1.7%	101,111	+ 3.7%
2003	184	2.2%	122,749	+21.4%
2004	189	2.7%	139,119	+13.3%
2005	195	3.2%	178,128	+20.0%
2006	202	3.6%	214,090	+20.2%
2007	207	2.5%	209,555	- 2.1%
2008	215	3.9%	201,727	- 3.7%
2009	215	0	158,332	-22.6%
Average		2.7%		8.9%

It takes only a quick glance to see there is extremely little relationship between the CPI and the trend of vacant land sale prices from the Northwest Montana MLS. The Northwest Montana MLS data includes all vacant land sales, sales without structural improvements such as cabins and homes. The number of sales in the MLS data bank ranges from 1,767 sales in 2005, at the peak of the recent real estate boom, to 336 sales in 2009.

Using the state's 3B escalation method of annual adjustment for 2004, the lease fee increase would have been a number between the 2003 CPI of 2.2% and a 20 year average real estate index of 6.53%. The result is a 2004 the lease fee increase of about 4% compared to the real 21% increase in real estate values in 2003. This would significantly short change the beneficiaries.

In 2010, using the 3B method, lease fees would increase around 3%, a split of the 0% increase in 2009 CPI and the 6.53% real estate index. In reality, real estate values went down a minus 22.6% in 2009.

I will be the first to admit the Northwest Montana MLS vacant land data is not the perfect model index to use for a change in real estate values. Note that I do not use the term escalation, but change in value. Real estate does not always go up, as evidenced by the 2007-2009 Northwest Montana MLS data.

I believe by carefully selecting pertinent data from both the Northwest Montana MLS data and Missoula MLS, a more accurate time trend data could be derived.

Northwest Montana experienced a real estate boom in the mid to late 1970's, then cooled off for a 10 year period. It wasn't until 1989 and 1990 that the real estate market became very active again. No one can predict when real estate prices will rise again.

The other high bound limit of the 3B escalation process is the 6.5% annual increase in real estate values during the 1983 to 2003 period as derived by the state. A major problem with this index is that it is not a market measure of current real estate trends in the local area. In real estate, there are major differences between property value changes in various locations around Northwest Montana.

The state's real estate index is a strange mix of other indices. One index is the average change in value of home sales in Montana from 1975 to 2009. What does the increase in home sale value between 1975 and 2009 have to do with lake front sales on Rogers Lake or McGregor Lake? This index includes home sales in Billings, located 600 miles from the subject lakefront lots. In addition, this index includes the value of structural improvements which usually represent 70-80% of residential value. The state is leasing vacant land, not improved property.

The real estate index is also influenced by the Neil appraisals done in 1976 and 1978. That data is over 30 years old. Back in the 1976 to 1978 era, banks were getting real estate mortgage interest rates of 12-15%. Now those same rates are 6%. Today's lower interest rates should be reflected in lower rates of return on rental property. There are thousands of recent vacant land real estate transactions, less than 5 years old, located in proximity to state leased land that could provide much more reliable change in real estate value trends. There is no need to use historic data from hundreds of miles away.

4. Other Trust Fund Rates of Return

The constitutional and supreme court ruling pertains to all state leases, not just residential and recreation leases. Each year the state sells millions of board feet of timber. Those timber sale prices are determined by current market conditions, not historic prices. According to the 2009 Annual Report for Trust Management Lands, data from that report indicates declining value of timber sold.

Year	Average Price per MBF
2007	$236
2008	180
2009	126

While declining timber stumpage value is of concern to the beneficiaries, they nevertheless sell timber at reduced prices because that price is market derived through a bid process in the open market. Residential and recreation leases should also be market derived.

State grazing leases are set annually with a formula tied to the price of beef. Again, those grazing lease prices are tied to the current market, not historic grazing lease trends. A recent study in Idaho indicated their grazing lease fees were yielding only a 1.1% annual return.

The 2009 Annual Report for the Trust Land Management Division indicates that between 2005 and 2009 lease income increased:

Grazing leases	Less than + 2 % per year
Commercial leases (since 2006)	+ 4.5% per year
Residential/recreation leases	+10.8% per year
Total Trust Revenues	+ 2.5% per year

The new Norris wind farm pays a rental rate of 3.1% of the electric generation revenues.

This data from other trust land revenue sources indicates that residential and recreation rental rates are already the highest of all trust revenue rates. Is that fair or market derived?

Overall, the 3B method is an attempt to develop lease fees using readily available data that can be obtained at little or no cost. The proposed increase of lease fees over the next six years in Northwest Montana, totals over $9,000,000. With those levels of fee increases, ***the state probably cannot win a court test of their lease fee determination using old data and data not pertinent to the lots being leased.*** They must use current market data and data from the neighborhoods where the leases are located.

The biggest lessor of recreation lots is the U. S. Forest Service. They adjust lease fees every 10 years with appraisals specific to each lake or group of lots. They do not have any annual escalation fees. Appraisals are done by independent fee appraisers who are obligated to meet with permitees or lessees.

C. Recent Idaho Study of Lease Rental Rates

In April of 2009, three very well qualified Idaho appraisers prepared a lease or rental rate study using improved lakeshore and non-lakeshore residential property rentals in the area where the State of Idaho had residential and recreation leases. They found and analyzed 17 rentals of improved properties (have homes or cabins). Their methodology was to start with the state assessed value of the land and improvements, and the annual rental income. From the rental income they deducted 1.7% of the improvement value, which was the annual recapture of the depreciating improvements over a 60 year life.

This left the remainder of the annual rental income attributable to land and improvement rent. Comparing the rent income to the assessed land and improvement values, resulted in an indication of the rental rate of return or lease rate of return. Their example was:

Assessed value-Land	$135,000
-Improvements	200,000
Total	$335,000

Monthly rent was $1,350 x 12 = $16,200 annual rental

Rent for Improvement Amortization
1.7% x $200,000= $3,400

Rent after Improvement Amortization $12,800

Base Rental Rate $12,800/$335,000 = 3.8% annual rental rate for the land & structures.

On the next two pages is a summary of their data and the land rental rates they derived.

Of special interest is the Regression Line showing a maximum of 5% annual rental rate for low value property and a **decreasing annual rental rate or rate of return for property as property became more expensive.**

The regression line developed in the Idaho Study indicates a 5% annual return for leased property with a value of $50,000, dropping to a 4% rate of return for $100,000 property and continuing to drop to 2% for property worth $350,000. This very clearly documents why Montana should not expect to get a 5% return (lease fee) for high value lakeshore property.

I spoke with one of the authors, Ed Morse, and asked how the state received this market data. His response was that the state (Idaho), "...came unglued". Idaho like Montana, is absolutely convinced that 5% represents a fair rental rate and will ignore market data to the contrary.

This data confirms other Montana market data that suggests 5% annual return for high value lakeshore is not consistent with what the real estate market will pay. Wealthy people, people

able to pay $10,000 to $20,000 per year for a rental payment, will almost always choose to buy and not rent. If property is rented by affluent people, it is on a short term basis with rental rates below 5%.

Again, this documents the necessity of the state asking for bids on existing vacant lots to develop actual current rental market data for lot lease fees.

The lack of meaningful bids for state lease proposals at Blue Bay and Lake Rogers during the mid-2000's, was more market evidence that a minimum bid price of 5% of fee value was too high.

EXHIBIT A

* Improvement Adjustment -1.7% assumes 60 yr. Life

Rent/mo.	Assessed Value			GRM	Annual GRM	Inverse	Imp Adjustment*	Land Rate y
	Land x	Imp	Total					
$925	$ 50,000	$ 100,546	$ 150,546	163	13.6	7.373%	-1.7%	5.673%
$1,395	$ 53,040	$ 152,742	$ 205,782	148	12.3	8.135%	-1.7%	6.435%
$1,200	$ 58,500	$ 165,057	$ 223,557	186	15.5	6.441%	-1.7%	4.741%
$1,225	$ 76,500	$ 191,890	$ 268,390	219	18.3	5.477%	-1.7%	3.777%
$800	$ 78,000	$ 90,240	$ 168,240	210	17.5	5.706%	-1.7%	4.006%
$1,100	$ 100,000	$ 188,400	$ 288,400	262	21.8	4.577%	-1.7%	2.877%
$1,195	$ 114,750	$ 120,500	$ 235,250	197	16.4	6.096%	-1.7%	4.396%
$1,350	$ 135,000	$ 212,584	$ 347,584	257	21.5	4.661%	-1.7%	2.961%
$1,495	$ 164,775	$ 186,604	$ 351,379	235	19.6	5.106%	-1.7%	3.406%
$2,500	$ 189,000	$ 418,370	$ 607,370	243	20.2	4.939%	-1.7%	3.239%
$750	$ 307,328	$ 36,871	$ 344,199	459	38.2	2.615%	-1.7%	0.915%
$1,000	$ 402,380	$ 82,730	$ 485,110	485	40.4	2.474%	-1.7%	0.774%
$1,195	$ 437,800	$ 122,520	$ 560,320	469	39.1	2.559%	-1.7%	0.859%
$2,200	$ 639,994	$ 129,937	$ 769,931	350	38.5	2.601%	-1.7%	0.901%
$4,500	$ 656,600	$ 341,995	$ 998,595	222	31.7	3.157%	-1.7%	1.457%
$5,500	$ 794,330	$ 471,080	$ 1,265,410	230	32.9	3.043%	-1.7%	1.343%
$4,995	$ 800,000	$ 622,340	$ 1,422,340	285	23.7	4.214%	-1.7%	2.514%

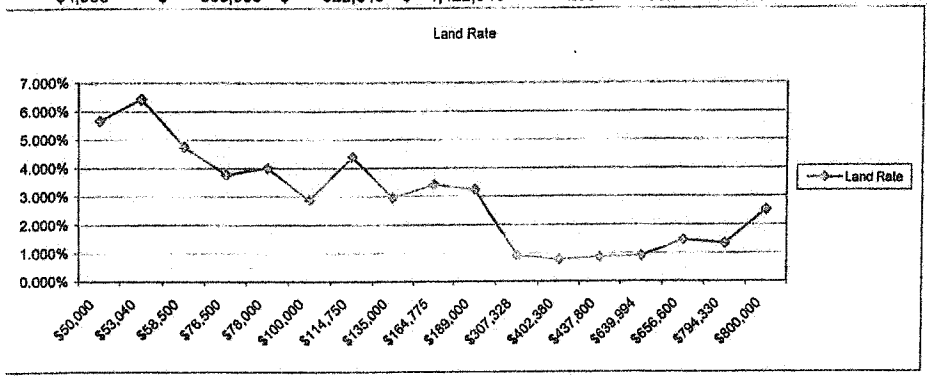


EXHIBIT B

Logarithmic Curve Fit
y=A+B(ln X)
A = 0.216712
B = -0.015301

0.037617035

Rent/yr	Rent/mo	ln x	y
1,881	$ 157	10.8198	5.0159%
1,995	$ 166	10.8788	4.9255%
2,201	$ 183	10.9768	4.7756%
2,878	$ 240	11.2450	4.3652%
2,934	$ 245	11.2645	4.3354%
3,762	$ 313	11.5129	3.9553%
4,317	$ 360	11.6505	3.7448%
5,078	$ 423	11.8130	3.4961%
6,198	$ 517	12.0123	3.1911%
7,110	$ 592	12.1495	2.9812%
11,561	$ 963	12.6357	2.2374%
15,136	$ 1,261	12.9052	1.8250%
16,469	$ 1,372	12.9895	1.6959%
24,075	$ 2,006	13.3692	1.1150%
24,699	$ 2,058	13.3948	1.0758%
29,880	$ 2,490	13.5853	0.7844%
30,094	$ 2,508	13.5924	0.7735%